In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 265

CHARLES TOWN, INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Section 482 of the Internal Revenue Code of 1954 confers discretionary authority upon the Commissioner of Internal Revenue to allocate income between two organizations which are controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or to reflect clearly the income of such organizations. Pursuant to that authority, the Commissioner here determined that taxpayer-petitioner (Charles Town) and Fair-

mount Steel Corp. (Fairmount) were controlled by Ben and Herman Cohen and that income reported by Fairmount from the operation of two horse-racing meets in 1958-1959 should be taxed to Charles Town. The Tax Court, sustaining the action of the Commissioner, found that "the total net income derived from the operation of the two racing meets in question was produced and earned by Charles Town." (Pet App. 52.) The Court of Appeals for the Fourth Circuit affirmed (372 F. 2d 415).

The decision below is correct and there is no conflict of decisions or any other basis for further review by this Court.

1. In early 1958, Ben and Herman Cohen, the operators of several enterprises including Pimlico Race Course, Baltimore, Maryland, were negotiating to purchase the Charles Town Race Course from the owner, Mrs. Helen Boyle. In May 1958, while the negotiations were in progress, the West Virginia Racing Commission advised Mrs. Boyle that she would lose her franchise if a summer meet was not held. Ben Cohen then began negotiations to lease the track and on May 20, 1958, a lease was entered into between Mrs. Boyle and "Ben Cohen acting for Charles Town Incorporated, a corporation hereinafter to be created." Charles Town, Inc. was incorporated on May 22, 1958, with Ben Cohen as its president, Herman Cohen as Secretary-Treasurer and Louis Pondfield, a cousin of the Cohens, as Vice President. One hundred shares of $10 par common stock were issued, with the Cohens each receiving one share and the remaining 98 shares going to Pondfield.

To provide the necessary capital for the operation of the meet, Housing Engineering Corporation, a corporation controlled by the Cohens, turned over $900,000 to Fairmount, another corporation controlled by the Cohens, and Fairmount then contracted with Charles Town to advance all monies necessary for the operation of the race meet in return for 90% of the profits. The advances made by Fairmount were in two series—$479,025 for the summer meet and $507,500 for the winter meet—each series being repaid in full by Charles Town within a few months. The profits distributed to Fairmount were $497,833.02 in 1958 and $234,466.84 in 1959. (Pet. App. 21-27, 37, 51.)

This round-robin would defy explanation but for the fact that Fairmount had allowable net operating loss carryovers from prior taxable years totaling $852,105.37. (Pet. App. 32.) By channeling 90% of the profits to Fairmount, where the income from the racing meets conducted by Charles Town would be offset entirely by the above-described income tax deductions, the Cohens hoped to avoid paying any income tax on the racing operation.

This case obviously presents the kind of manipulation which Section 482 was designed to combat. Taking into account the fact that Charles Town owned the lease of the racetrack property, obtained the requisite license and insurance, hired all the employees and paid all the bills (Pet. App. 35-45)—in contrast with the mere paper connection Fairmount had with the actual operation—it is clear that in any practical frame of reference, Charles Town earned the income

and should pay the tax on such income. *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422. The anticipatory assignment of income to Fairmount is ineffective to shift the tax from the entity which earned it. *Lucas* v. *Earl*, 281 U.S. 111, 114-115.

2. In Section 482, Congress used the phrase "direct or indirect" to describe the kind of control sufficient to make that provision operative. It also refrained from defining control in terms of stock ownership. Thus, Congress made plain that the existence of common control of two or more organizations is to be determined in economic terms rather than by any set rule or formula. Consistent with the terms of Section 482, the term "controlled" has been defined as including "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise." Section 1.482-1(a)(3) of the Treasury Regulations on Income Tax (1954 Code). In examining the facts and circumstances of the case, including the course of events which led up to the formation of petitioner, the courts below have followed, rather than misapplied, the statutory directive.

There is no merit to petitioner's contention that Section 482 is unconstitutionally vague because the term control is not precisely defined. It has long been recognized that Congress intended to give the Commissioner broad power to deal with the economic realities of particular situations. *Spicer Theatre, Inc.* v. *Commissioner*, 346 F.2d 704 (C.A. 6); *National*

Securities Corporation v. *Commissioner*, 137 F.2d 600 (C.A. 3). As this Court noted in *American Power and Light Co.* v. *Securities and Exchange Commission*, 329 U.S. 90, 105:

> The legislative process would frequently bog down if Congress were constitutionally required to appraise beforehand the myriad situations to which it wishes a particular policy to be applied and to formulate specific rules for each situation. Necessity therefore fixes a point beyond which it is unreasonable and impracticable to compel Congress to prescribe detailed rules; it then becomes constitutionally sufficient if Congress clearly delineates the general policy, the public agency which is to apply it, and the boundaries of this delegated authority.

See also *Hampton & Co.* v. *United States*, 276 U.S. 394.

3. Petitioner's assertion that the instant case conflicts with *Rooney* v. *United States*, 305 F. 2d 681 (C.A. 9), is unsound. Assuredly, *Rooney* stands for the proposition that common control must exist at the time "when the taxpayers deal with each other," but that standard clearly was applied by both courts below in this litigation. As pointed out by the court of appeals, the Cohen brothers "controlled the negotiations and entire course of events which led to the creation of Charles Town, the acquisition of the lease for the Race Course, and the execution of the agreement between Fairmount and Charles Town assuring essential capital for the new corporation and their continued control of the business venture." (Pet. App.

10.) Petitioner's main argument is that the courts below did not afford critical significance to the fact that Louis Pondfield, a cousin of the Cohens, formally owned 98% of its stock. In view of the fact that Pondfield's 98% ownership represented an investment of $980, whereas a total of $986,525 was advanced to Charles Town through the corporations controlled by the Cohens, the courts below quite properly rejected petitioner's argument that the Cohens "controlled" petitioner only through the written contracts which it entered into with Fairmount. In the perspective of economic reality the control of petitioner by the Cohens was manifest, including control at the time when petitioner and Fairmount "dealt with each other."

4. Similarly, petitioner mistakenly contends that this case is inconsistent with *Davis* v. *United States*, 282 F. 2d 623 (C.A. 10), which indicates that a Section 482 allocation cannot be made if the division of income made by the parties is the same as it would have been if they had dealt with each other at arm's length. (Pet. 9-10). The transactions involved in this case bear no resemblance to an arm's-length agreement and the Tax Court found that the amounts advanced by Fairmount to Charles Town were in the nature of an equity investment. Since an investor can not agree to divide taxable income with the corporation, see *Lucas* v. *Earl*, *supra*, it was quite properly concluded that the entire earnings of Charles Town should be included in its taxable income. See *National Carbine Corp.* v. *Commissioner*, *supra*.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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